

Sri Kumar Pappu Singh V/s DCIT, Andhra Pradesh

I.T.A. No. 270 /Viz/2018

Renouncement of rights in favour of a relative is not taxable under Section 56(2)(vii)(c).

1. Background:

The issue of taxability of rights issue of shares in the hands of the shareholders under Section 56(2)(vii)(c) of the Income tax Act, 1961 (for short, 'the Act') has been a contentious issue. The Revenue argues that if rights shares are allotted at a price lower than the fair market value (for short, 'FMV'), the recipient derives a benefit, which is taxable under Section 56(2)(vii)(c) of the Act.

The Hon'ble Supreme Court has held in *Khoday Distilleries Ltd. v CIT* (2008) 307 ITR 312 that 'allotment' of shares and 'transfer' of shares are two separate transactions. Hence, it is arguable that allotment of shares is not covered within the ambit of Section 56(2)(vii)/(viiia) of the Act.

In case of *Sudhir Menon HUF v ACIT* (2014) 148 ITD 260, the Hon'ble Mumbai Tribunal held partially in favour of the assessee that although a rights issue of shares attracts the provisions of Section 56(2)(vii)(c), there will be no tax implications if the rights issue was exercised by all shareholders in proportion to their shareholding in the company. The Tribunal held that Section 56(2)(vii)(c) would apply in case of disproportionate allotment of rights shares.

The latest case of *Sri Kumar Pappu Singh*, discussed in this note, clarifies that even in case of disproportionate allotment of rights shares, if the renunciation of rights is between relatives, the provisions of section 56(2)(vii) would not be attracted owing to the specific exemption provided in case of gift from relatives in that section.

2. Facts:

- a. Sri Kumar Pappu Singh (for short 'the Assessee') was a shareholder in M/s. Jai Maakali Poultry Products (for short 'the Company'), holding 76% of the total capital of Rs.1,00,000/-. The Company had other shareholders who were all 'relatives' of the Assessee as defined in the *Explanation* given in Section 56(2)(vii) of the Act.
- b. During AY 2013-14, the Company offered rights issue of shares to all its shareholders, i.e., 1,50,000 equity shares were offered at @ Rs. 100/- per share, vis-a-vis FMV of Rs. 416/- per share. Except the Assessee, other shareholders of the Company did not exercise their respective right to get additional shares in the Company. Hence, all shares were allotted to the Assessee.
- c. Eventually, the difference between the FMV of the shares and the purchase consideration was taxed in the hands of the Assessee under section 56(2)(vii)(c) of the Act

3. Issues under consideration before the Hon'ble ITAT, Vishakhapatnam.

Whether renunciation of rights by one close relative in favour of another is covered by the exception carved out under Section 56(2)(vii) and consequently not taxable under section 56(2)(vii).

4. The Tribunal held in favour of the Assessee and held as under:

- a. Section 56(2)(vii)(c) of the Act is brought as an anti-abuse measure, as it seeks to tax the understatement in consideration as income in the hands of the recipient of the asset. The transaction between close relatives should not be seen as introducing black money or evasion of tax. Hence, the transactions between close relatives are outside the scope of application of Section 56(2)(vii)(c) of the Act.
- b. Though the shares are allotted to the Assessee, the entire shareholding of the Company is retained by the family, and no share was allotted to the outsiders. Surrender of rights of close relative in favour of another is covered within the exception provided in the said section. Thus, transfer of rights to subscribe rights shares between relatives does not attract any tax liability under Section 56(2)(vii)(c) of the Act.

- c. Reference was made to the decisions of the Madras High Court in CIT v. Kay Arr Enterprises (2008) 299 ITR 348 and the Karnataka High Court in CIT v. Nagaraja Rao (2012) taxmann.com 101, wherein it has been held that transfer of shares under a family arrangement is not exigible to capital gains tax.

5. Comments:

Recently, CBDT had issued a Circular No. 10_ dated 31.12.2018 clarifying that a transaction of 'issue of shares' is not covered within the ambit of section 56(2)(viiia) and that the word 'received' used in the section should be construed narrowly to cover only cases of transfer of shares. However, said Circular presently stands withdrawn vide Circular No. 2 dated 04.01.2019. It is expected that a new circular would be issued on said issue clarifying the Revenue's stand in the matter. Pending such clarification, foregoing decision would help in cases of rights issue by family owned companies.